Antares Capital

2024 ASSET MANAGEMENT OUTLOOK

Perspectives On Private and Liquid Credit

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Private Credit: 5 Key Themes for 2024 and beyond.

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Uncertainty "Yields" Opportunity

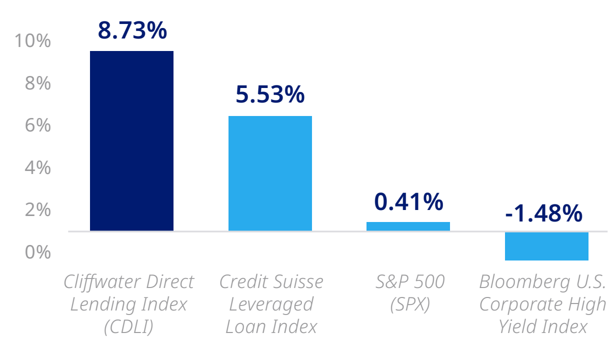
The Most Anticipated Recession that Never Came...

If one word were to characterize 2023 from an investment perspective, it would be resilience. Both markets and the economy faced numerous headwinds including high inflation, the sharpest rise in interest rates in four decades, regional bank woes, and threatening geopolitical developments. However, despite these challenges, the U.S. economy powered ahead, fueled by robust fiscal spending, excess consumer savings from the pandemic stimulus and continued strength in the labor market. Real U.S. GDP growth of 2.5% in 2023 enabled most U.S. middle market companies to maintain EBITDA margins and achieve 12.4% year-over-year revenue growth on average for 2023, according to the National Center for the Middle Market. This in turn has resulted in a relatively benign (if higher) default environment despite the higher interest cost burdens.

Meanwhile, higher base interest rates and wider spreads drove first-lien loan yields to as high as 12%, leading some to anoint the current period as a "golden age" for private credit. Indeed, both direct lending and leveraged loans have markedly outperformed high yield and equities in the period since the Federal Reserve began raising interest rates in March 2022 through 3Q 2023 (*Figure 1*), and we expect this to continue to be the case for full-year 2023 when 4Q23 direct lending data is released. Direct lending execution also remained in favor vs. bank syndicated loan solutions, with direct loans accounting for 70% of the sponsored middle market and continuing to make inroads into the large corporate market. However, on the negative side, higher interest cost burden and economic uncertainty also significantly dampened PE investment activity. U.S. sponsored middle market LBO volume fell 41% vs 2022 with add-on volume falling by a lesser 25% which was of relative benefit to incumbent lenders with large portfolios.

FIGURE 1

Annualized Performance Since the Fed Started Raising Rates (Mar 2022 - Sep 2023)[1]

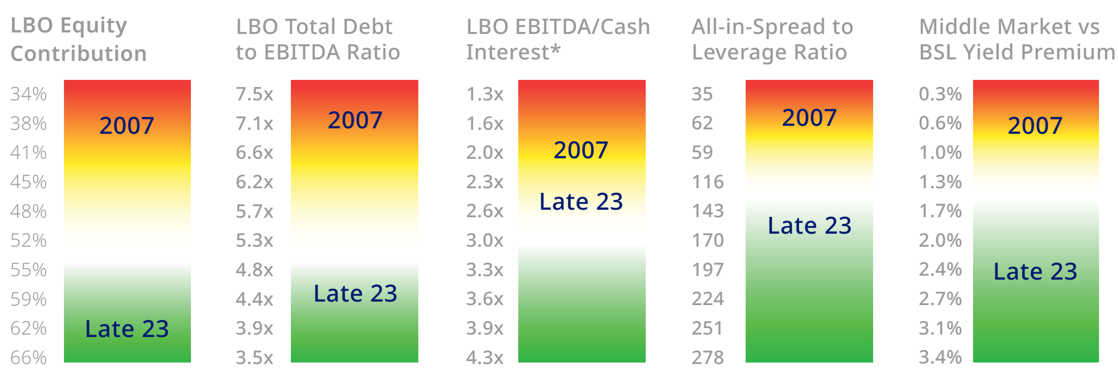


A Green Light for Deploying Capital on Most Key Metrics

As we enter 2024, we believe the read on most key middle market loan metrics suggests the opportunity for prudently deploying new private debt capital remains quite favorable. All-in yields and the middle market yield premium remain at the high end of their long-term range; total debt-to-EBITDA leverage has declined below its long-term average; PE sponsor LBO equity contributions are near record highs; and first-lien yield per unit of leverage (excluding unitranche) remains near the highest it has been since at least 2013. Less constructive is LBO EBITDA-to-cash interest given the spike in interest rates. This metric varies based on the level of leverage employed and is currently in the 1.5-1.9x range for deals with total leverage above 5x. This is an acceptable level of cushion that should improve if earnings hold up as expected and interest rates decline as the Fed fund futures curve implies, however, there is less cushion than the ~2.5x level seen in recent years. (*Figure 2*)

FIGURE 2

Middle Market Loan Thermometer – On the Run Vintage Statistics Ranges 2007-2023[2]



*The data for LBO EBITDA to cash interest shown includes some higher rated, lower leveraged and lower yielding loans and is based on historical, unadjusted interest rates.

01

Higher for Longer

The notion of interest rates staying “higher for longer” or even “higher forever” is now widely accepted relative to a backdrop of near zero interest rates over most of the past 15 years. However, how far and how fast rates fall to over the next two or so years to their new “normal” equilibrium level remains very much up for debate.

As we enter 2024, signs of slowing growth, benign inflation data and easing wage pressure in conjunction with a dovish “pivot” in the Fed’s language and dot plot projections have all led investors to begin discounting multiple rate cuts in 2024. Historically, the median time for the first rate cut after the final Fed rate hike is around thirteen months, which would suggest the first interest rate cut to occur in August 2024. However, the Fed funds futures curve currently appears to be discounting a first cut of 25 bps as early as March, as of the time of writing in mid-January. (*Figure 3*)

While we believe rates are likely to move lower in 2024, we currently expect the Fed to be somewhat slower to cut rates than the market anticipates given the underlying strength of the U.S. economy. Real GDP grew faster than expected, at an annualized rate of 3.3% in 4Q23 and a data-dependent Fed will likely be wary of prematurely declaring victory against inflation. In addition, a significant loosening in financial conditions in the last two months of 2023, as measured by the Chicago Fed National Financial Conditions Index — tracking indicators across money markets, credit and equity markets, and the banking system — has reduced the need for the Fed to act quickly. This, in conjunction with the upcoming U.S. presidential election, may make the Fed less inclined to engage in an aggressive easing cycle absent an exogenous economic shock. (*Figure 4*)

FIGURE 3

Fed Fund Futures Curve[3]

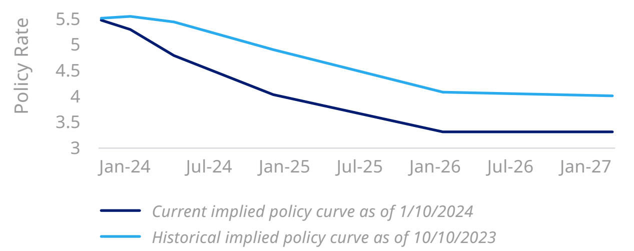
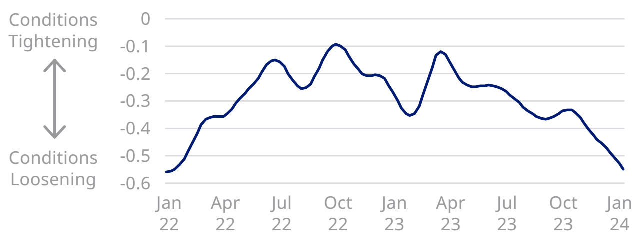


FIGURE 4

Chicago Fed National Financial Conditions Index[3]

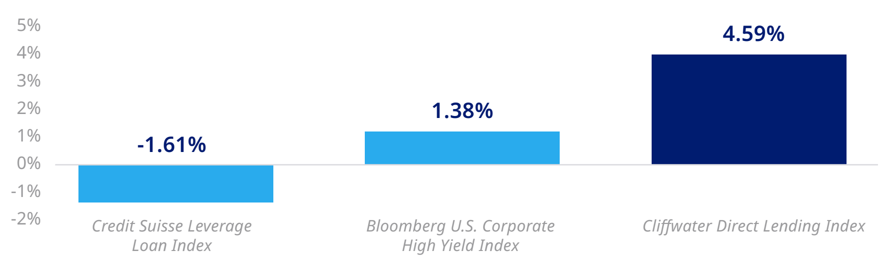


Implications of Falling Base Rate for Direct Lending Performance

While direct lending returns have benefited from the steep increase in base rates, it’s important to note that many of the all-weather attributes of direct loans (e.g., seniority in the capital structure; covenants; illiquidity premium and rate floors) may also help direct lending strategies outperform other asset classes during periods when interest rates are falling. As base interest rates move lower, all-in first-lien direct lending yields will no doubt decline from their current levels of ~11-12% to perhaps a still attractive level of ~9% in 2024-25 based on the current SOFR curve. However, lower base rates will also help ease pressure on borrower’s cash flows (thereby lowering loan loss risk) and improve the economics of PE M&A investment activity. Interestingly, in previous interest rate cycles, after the first interest rate reduction, direct lending has historically outperformed on average over a two-year period. While prior easing cycles reflected in Figure 5 coincided with recessions (GFC and COVID), we believe the next easing cycle will likely occur without a recession, supporting higher performance for both public and private credit than what has historically occurred.

FIGURE 5

Average Two Year Annualized Peformance After First Interest Rate Cut (2007-2021)[4]



02

Urge to Merge – PE M&A Investment Activity Should Recover Some in 2024; Boom in 2025-26?

The Headwinds that Constrained M&A Activity in 2023 Remain, but Appear to be Dissipating:

- Falling interest rates will lead to declining acquisition financing costs and should help kickstart depressed M&A activity which is already beginning to show signs of rebounding in 4Q23 (*Figure 6*). Also, prospects for a "soft landing" in 2024 have improved with an "earnings recession" appearing to have ended in 3Q23 and with consensus 2024 S&P 500 EPS forecast to grow 11%.

- PE buyout-specific dry powder has risen over 30% since 2021 to an estimated record of $640bn in North America, raising pressure on sponsors to deploy capital (*Figure 7*). In addition, pressure to sell has been building as LP demands for return of capital have risen following a multi-quarter dearth in PE investment exit activity. Improved prospects for a pickup in the depressed IPO market in 2024 could also help with the recycling of PE capital into new M&A investment.

- LBO purchase price multiples (PPMs) have started to compress with valuation volatility subsiding as clarity around the path of interest rates is achieved. The average PPM for middle market LBOs has decreased to 11.2x as of year-end 2023, from 12.5x in 2022. In addition, private market acquisition multiples look increasingly cheap relative to public market multiples. (*Figure 8*)

FIGURE 6

Sponsored Middle Market M&A Volume Depressed[5]

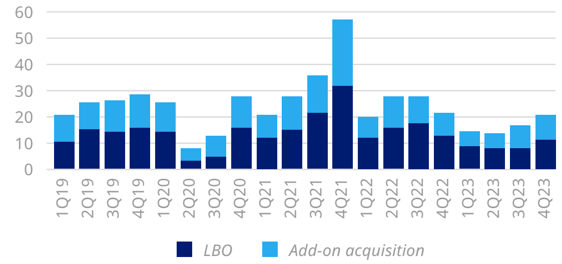


FIGURE 7

North American-Focused PE (Buyout Only) Dry Power Surges[5]

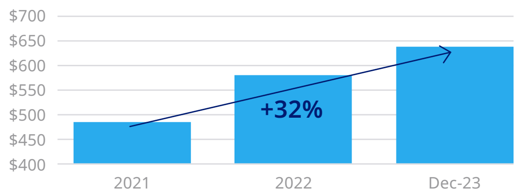
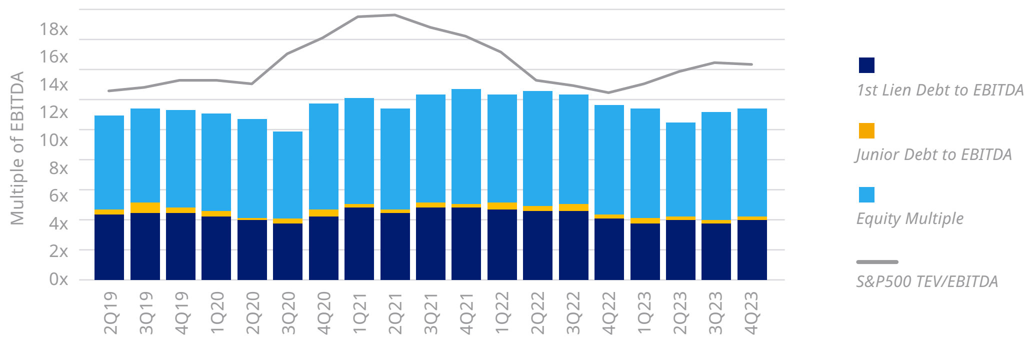


FIGURE 8

MM LBO Purchase Price and Leverage Multiples Contracting[5]



The 2024 presidential election-related uncertainties could keep some market participants on the sidelines. Nevertheless, on balance, we believe the odds favor at least a modest pickup in PE investment activity in 2024 following two years of decline, with the possibility of a sharper pickup in 2025-26. Note that in the 40 years the London Stock Exchange Group (LSEG) has kept records, the value of mergers and acquisitions has never dropped three years in a row.

03

Private Credit Tailwinds Continue to Blow

The secular tailwinds that have powered double-digit growth of direct lending over the last few years appear poised to continue:

Runway for Growth Looks Promising; Total Addressable Market Expanding

- Private credit assets are still a relatively small percentage of overall alternative assets, representing only ~14% of North American alternative assets under management (AUM) as of 2022. Preqin estimates that total North American private credit AUM will reach $1.7tn in 2028 – nearly double 2022 levels. With the Federal Reserve calculating that there are $12.2tn in loans outstanding from U.S. banks as of November 2023[6], even at $1.7tn, private credit assets would constitute a relatively small component of the U.S. financial system. (*Figure 9*)

- Based on a November survey from Preqin, investors remain committed to private credit in 2024, with 92% of respondents intending to maintain or increase their allocation. Within private credit, 67% said direct lending presented the best opportunity and 90% of survey participants said private credit met or exceeded performance expectations.

- In terms of loan issuance, PE ownership penetration in the U.S. middle market remains relatively low by our estimate, providing ample runway for growth in the core middle market. We estimate that PE platform and add-on company count only equates to around 14% of all middle market companies. (*Figure 10*)

FIGURE 9

North America Private Credit AUM ($bn)[7]

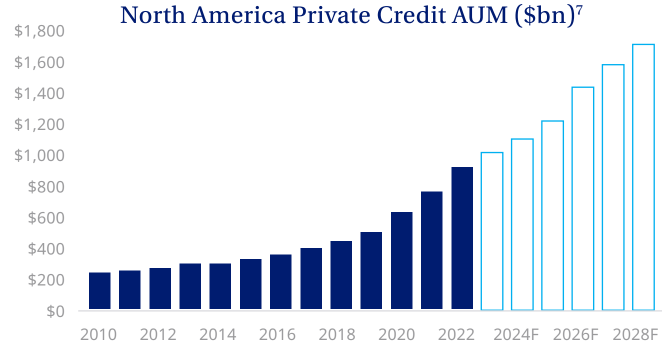
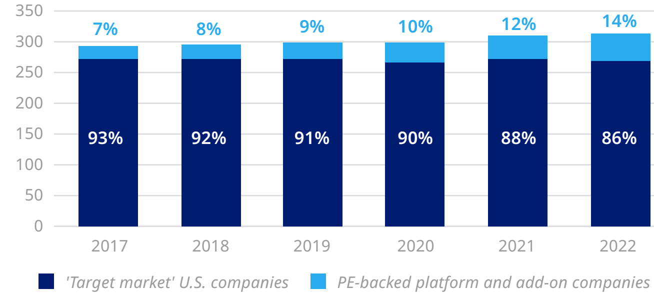


FIGURE 10

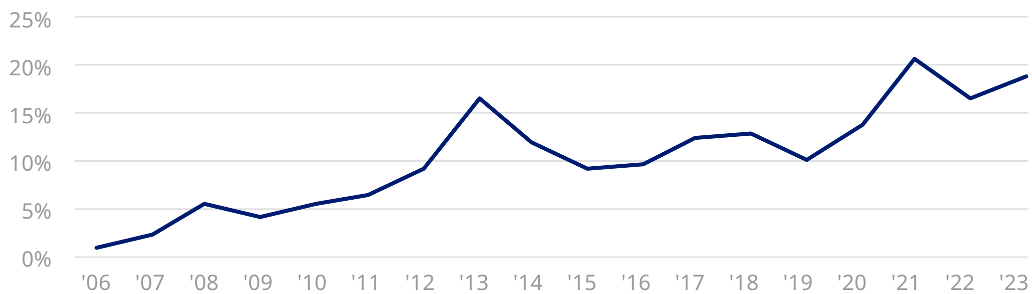
PE-Backed 'Middle-Market' Platform and Add-On Company Count as a Portion of All U.S. 'Middle Market' and Potential Add-On Companies. %[8]



Also noteworthy, although direct lending AUM has grown sharply, direct lending dry powder still looks low relative to PE buyout dry powder. Some of this is explained by the fact that direct lenders historically were limited to targeting only the PE middle market buyout segment. However, that has been changing of late with direct lenders increasingly funding $1bn+ sized deals that were historically financed in the broadly syndicated loan (BSL) market. (*Figure 11*)

FIGURE 11

Ratio of Direct Lending Dry Powder to PE Buyout Dry Powder Ratio[9]



– **Direct lending value proposition continues to resonate amid periodic syndicated market dislocation.** Market volatility and the regional bank failures last year reduced bank risk appetite to underwrite and syndicate through most of 2023, bolstering direct lending market share gains. Direct lending already dominates U.S. middle market loan originations to sponsor-backed borrowers (capturing 75% share in 4Q23) but has also been making significant inroads into the large corporate market with "jumbo" (>$1bn) unitranche loans proliferating in recent years. Large corporate direct lending volumes have grown from near zero in 2017 to $113bn in 2023. (*Figures 12 & 13*)

Looking forward, restrictive bank credit availability as indicated by the Fed's Senior Loan Officer Opinion Survey (SLOOS) suggests continued opportunity for further direct lending inroads heading into 2024 (*Figure 14*); however, syndicated markets appear to be recovering of late. Regardless, while there will be cyclical ups and downs in syndicated market appetite, we believe direct lending remains poised to continue to gain share from the bank-dominated syndicated market over time reflecting direct lending's advantages including speed, simplicity (e.g. no ratings required), certainty of execution/no flex, confidentiality, and ability to work with a small group of trusted lenders if amendments or workouts become necessary.

FIGURE 12

Direct Lending $Vol Share of U.S. Sponsored MM[10]

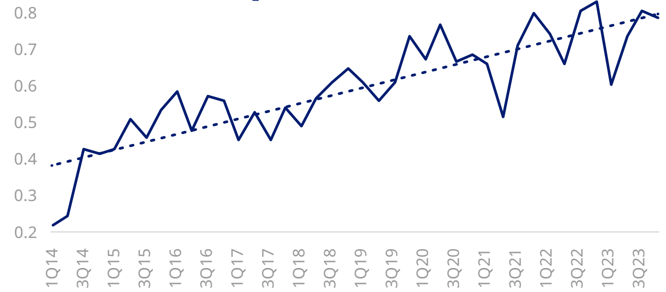
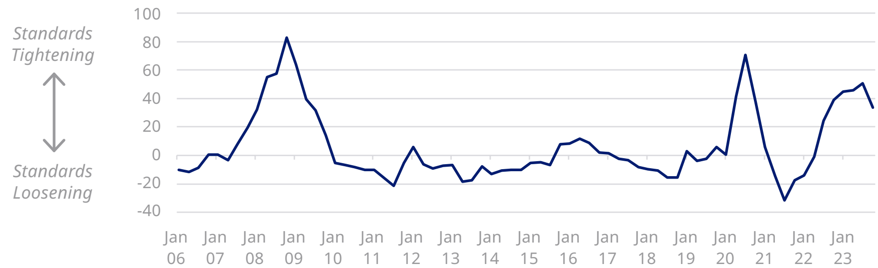


FIGURE 13

Direct Lending $Vol Share of Large Corporate Market[10]

FIGURE 14

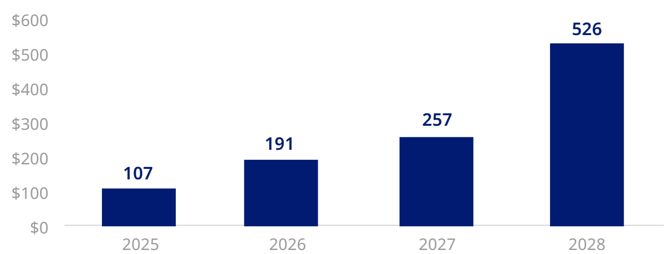
Net Percentage of Domestic Banks Tightening Standards for Commercial and Industrial Loans to Large and Middle-Market Firms[11]



– **An upcoming "maturity wall" to allow private credit to replace high yield and syndicated bank loans.** The amount of performing debt across the U.S. leveraged loan market maturing in 2025 is expected to reach $107bn, further climb to $191bn in 2026 and peak at $526bn in 2028[12]. Looking at sponsored-only bank-dominated maturities yields a similar picture. We expect to see issuers increasingly consider private credit options when refinancing their syndicated loans depending on their specific needs. (*Figure 15*)

FIGURE 15

Maturity Breakdown of Performing Loans ($bn)[12]



- **New products and markets to proliferate.** We expect the broader private credit market to continue to grow across segments and geographies especially as banks are further disintermediated. We also expect to see growth in new products and bespoke financing solutions such as NAV loans. While NAV loans have faced some controversy of late related to certain cases, we believe properly structured transactions can and will provide compelling/efficient solutions that maximize value for sponsors and their LPs. Pitchbook LCD estimates the market for NAV loans of about $100bn today could triple by 2025 and more than double again by 2030. We are also witnessing an expansion of middle market CLO issuance as direct lenders turn to CLOs to finance their lending business. According to LSEG LPC, private credit CLO growth took off in 2023, capturing 23% of CLO issuance vs. an average of 12% over the previous five years.

- **Performance to remain strong.** The Cliffwater Direct Lending Index (CDLI) was up 8.9% YTD as of 3Q23. Over the last 10 years, the CDLI has delivered an 8.87% annualized return, double the performance of leveraged loans (+4.33%) and high-yield bonds (+4.24%). (*Figure 16*) Looking forward, we believe direct lending will continue to exhibit very favorable risk-adjusted returns. Higher yields driven by "higher for longer" base interest rates, an "illiquidity" yield/spread premium, and moderate default rates should support performance in 2024. (*Figures 17&18*) Longer term, the fundamentals for direct lending are compelling with Cliffwater forecasting an attractive 7.6% unlevered (9.5% levered 1:1) return for its direct lending index over the next 10 years as of January 2024, a higher rate of return than forecast for both public credit (excluding BDCs) and equities. (*Figure 19, on next page*)

FIGURE 16

10-Year Growth of $100 (Oct 2013 - Sept 2023)[13]

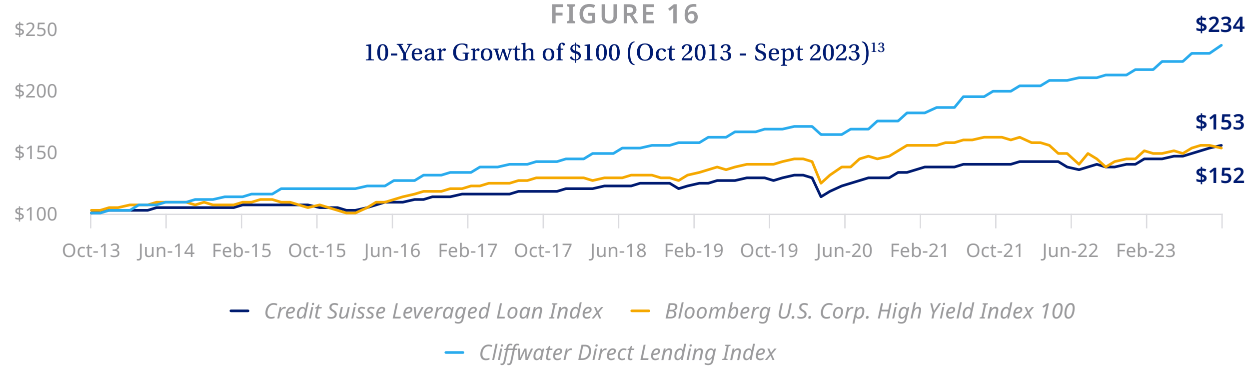


FIGURE 17

Average 1st Lien Term Loan Yield's Surge[14]

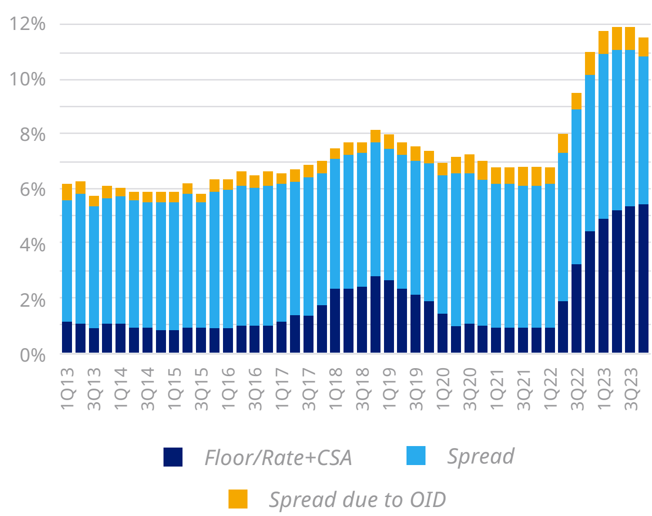


FIGURE 18

Avg. 1st-Lien MM Term Loan Spread[15]

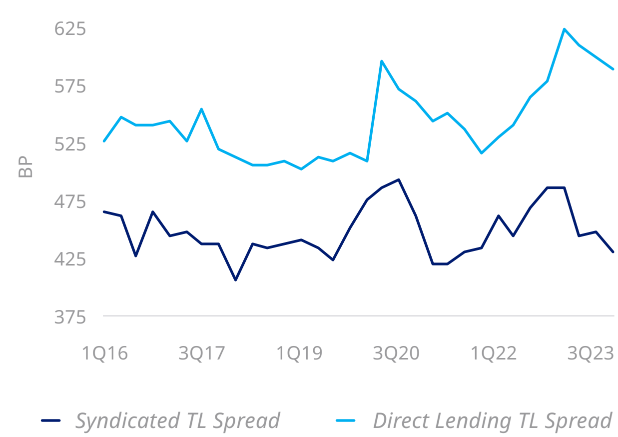
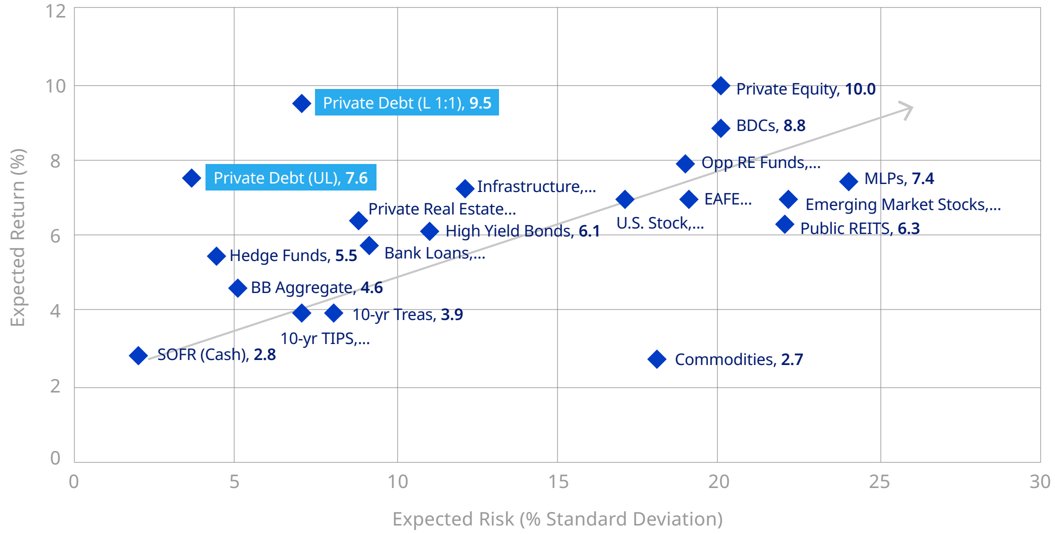


FIGURE 19

Cliffwater's 10-year Expected Asset Class Return and Risk[16]



More broadly speaking, we believe a strong argument can be made for investors to increase credit exposure generally – be it liquid or illiquid given the potential for near or above equity-like returns but with less volatility and downside risk (*see liquid credit chapter*). As seen in Figure 20, the equity risk premium has declined to levels that suggest equities are not offering much of a premium in earnings yield vs. a "risk free" return.

FIGURE 20

Equity Risk Premium[17]

"Democratization" of Private Credit

Retail investors are attracted to private credit for many of the same reasons that institutional investors are, namely: income generation, low volatility, strong historical relative performance and decorrelation to traditional investments. The asset allocation benefits of private credit have been particularly apparent of late in the context of the elevated correlation between stocks and bonds. In 2022, we saw this lead to the worst performance of the traditional 60/40 portfolio in decades.

LSEG LPC estimates that private credit BDC assets reached over $300bn in 3Q 2023, a significant rise from the estimated $180bn in 1Q 2021. In our view, there is meaningful opportunity for private credit to make further inroads with "retail" investors given their low level of exposure to alternatives, and private credit in particular. According to a study by Bain & Co., individual investors hold roughly 50% of the estimated $275tn to $295tn of global AUM yet constitute only 16% of alternative investment AUM.

04

Fat Tails – Another Year of Living Dangerously

A "Permacrisis" Story of Imponderable Geopolitical Risks

It is hard to watch the news of late and not feel like we are approaching an end of days. Thankfully, some threats like COVID and inflation have dissipated with the U.S. economy and most sponsor backed middle market companies having proven to be quite resilient. However, threats continue to abound. War in Ukraine and Gaza grind on with a terrible human toll and threat of escalation, China's growth is slowing and tensions over Taiwan remain. Closer to home, we have a high stakes and potentially very contentious presidential election looming with ever-mounting debt and deficits. The world is becoming increasingly polarized/multipolar with political volatility and trade barriers rising. Climate change and higher base inflation are also likely to exacerbate the pernicious effects of rising income inequality. In such a world, bad things can happen and the world is no longer always "mean reverting" as Dr. Mohamed El-Erian who co-authored "Permacrisis: A plan to Fix a Fractured World" noted at our investor day conference in October 2023. There are multiple equilibria points and bad situations can feed off one another.

In such a world, we believe exposure to private credit as an asset class makes sense, particularly in the context of tilting toward "real" capital protection without much if any trade-off of capital appreciation. Indeed, protection is afforded by 1) being in a first-lien position in the capital structure with covenants; 2) sponsor backing and equity cushion; 3) a natural inflation hedge that comes with a floating rate structure, and 4) a low volatility reflecting a non-mark to market/ buy and hold asset with high recovery rates/lower loss rates in the event of default - all speak to direct lending's appeal in an uncertain world (*Figure 21*). Interestingly, if one looks at the worst 5-year trailing performance of major asset classes going back to 2004, direct lending has a positive 6.9% return vs. less than 2% for high yield and leveraged loans, and a loss of 1.7% for the S&P 500. (*Figure 22*)

FIGURE 21

Average Annual Loss Rate (2011-2022)[18]

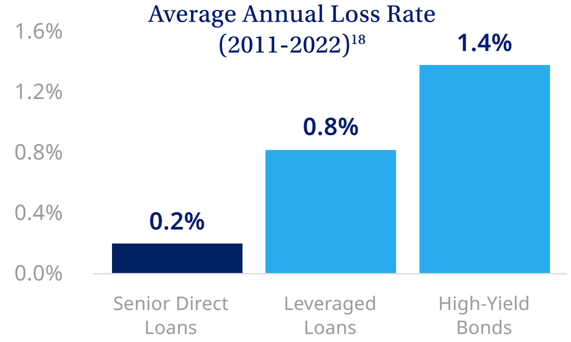
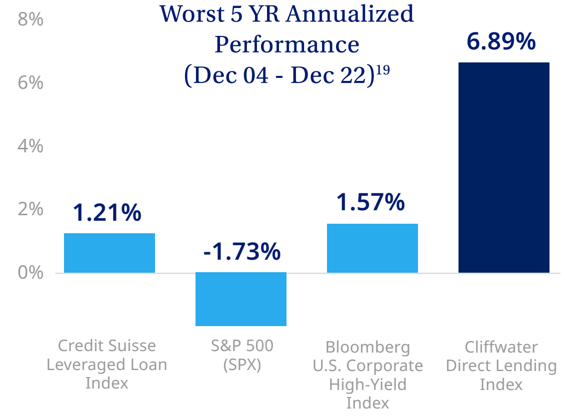


FIGURE 22

Worst 5 YR Annualized Performance (Dec 04 - Dec 22)[19]



The Future is Now: AI, Life Sciences, and Energy Advances to Drive Productivity and Disruption

Of course, fat tails are present on both sides of the curve of potential outcomes and there is also much to be optimistic about, as unsettling as the pace of change may be. The "solution" to the "Permacrisis" is primarily to drive higher global economic growth that allows for greater investment in solutions to large and complex problems – and the key to higher economic growth is productivity growth. While "techno-optimism" of the past hasn't panned out much in the productivity numbers to date, there is reason to believe this may be changing. Productivity has seen rapid growth in the last two quarters even before the impact of generative AI which just exploded on the scene as a powerful tool to augment humans across broad swaths of the economy. Miraculous developments in life sciences and energy technology also hold much promise.

However, such powerful tools can also be a threat and their impact – even if a net benefit – may be disruptive and uneven across sectors. Lenders will need to leverage AI tools to their and their LPs' advantage in analyzing vast amounts of data quickly and accurately to enhance returns/lower default rates, suggest origination opportunities and to automate processes to reducing costs/fees – all while ensuring cyber security/privacy issues are addressed. Savvy PE sponsors will no doubt find fresh pastures for value creation that direct lenders can help finance, but loan underwriters will also need to be evermore mindful of disruptive threats in their pipeline and across their portfolios.

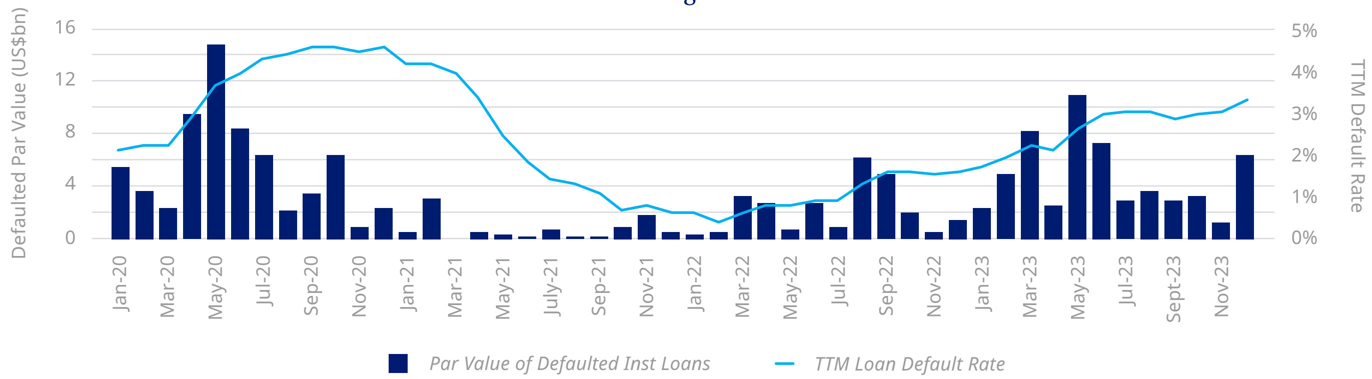
Performance Dispersion Likely to Widen

Defaults Expected to Remain Low but Performance Dispersion Among Lenders Likely to Increase

As of late December 2023, Fitch is forecasting both leveraged loan default and high yield default rates to rise from 3.0-3.5 in 2023 to 3.5-4.0% in 2024 for leveraged loans and 5.0-5.5% for high yield before falling back to a 2.0-3.0% rate for both segments in 2025. (*Figure 23*) By comparison, KBRA DLD, which recently started tracking private credit defaults, is expecting direct lending defaults in 2024 for sponsored loans to be 2.75%, up modestly from 2.50% in 2023.

FIGURE 23

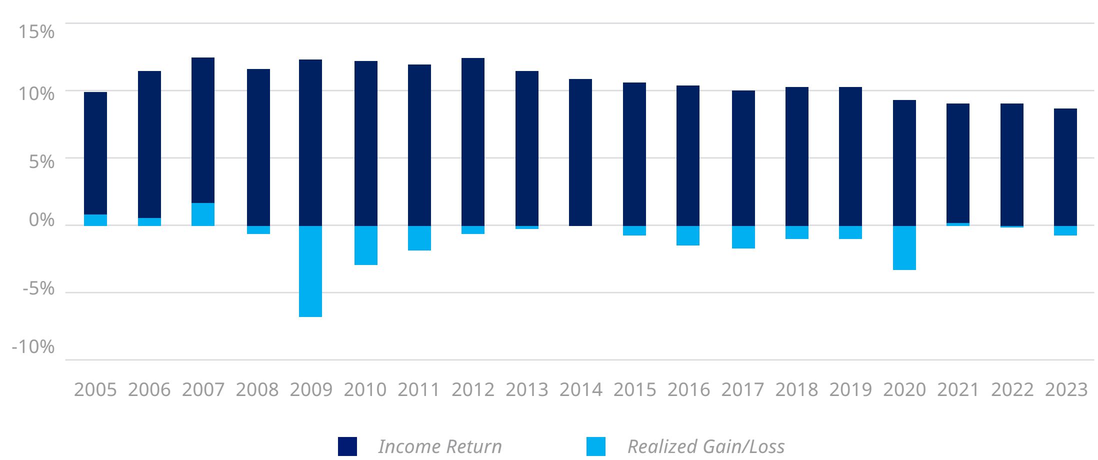
Institutional Leveraged Loan Defaults[20]



Although an economic 'soft landing' appears increasingly likely with default rates remaining relatively benign and perhaps even falling in 2H 2024, less favorable scenarios are still very much on the table. Should the economy fall into recession, we believe direct lending as an asset class will still be well positioned given strong structural protections (seniority in the capital stack; covenants, etc…), sponsor equity support, and a less-cyclical industry focus that has translated into historically low realized loss rates (*Figure 24*). We see private debt as an "all-weather" asset class that can provide attractive risk-adjusted returns throughout credit cycles.

FIGURE 24

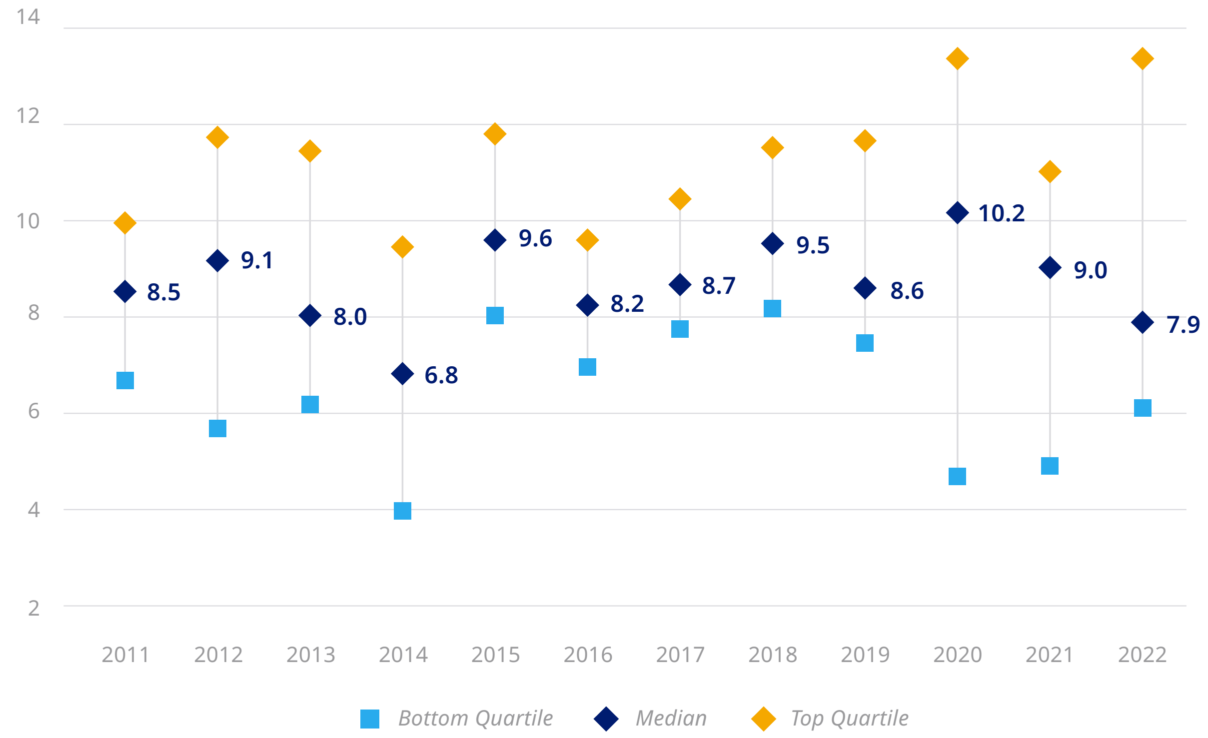
CDLI Income Return vs. Realized Losses (2005 - Sept 2023)[21]



That said, we believe that in 2024, the higher cost of capital is likely to impact sectors and firms differently and against this backdrop, there will likely be an increasing dispersion in direct lender GP performance. *(Figure 25)* Performance dispersion tends to increase alongside defaults, which should not come as much of a surprise given alpha in direct lending is primarily derived from minimizing defaults and maximizing recoveries. Given the expectation for a modest increase in defaults, managers that have dedicated credit advisory teams focused on workouts and restructuring to maximize recoveries will likely fare better than smaller, less experienced managers.

FIGURE 25

North America Direct Lending IRRs By Vintage[22]



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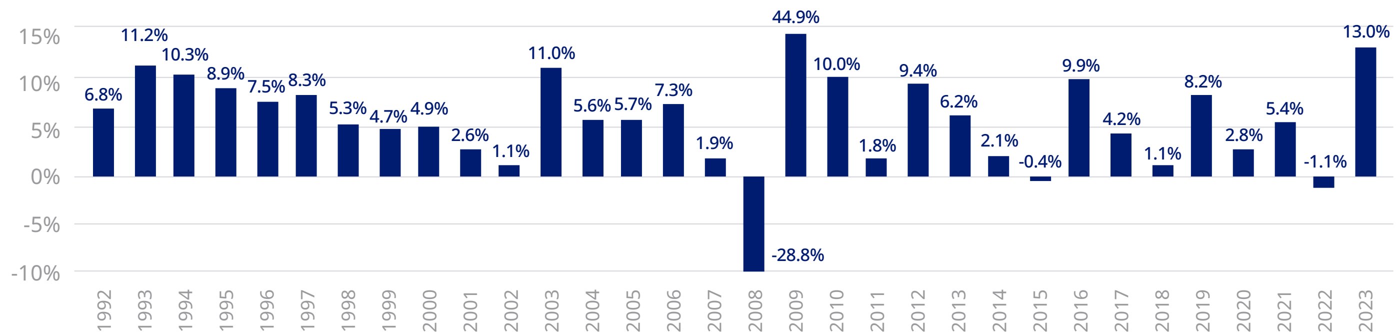
Note: Unless otherwise stated, statements above reflects Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially. Cross-referenced footnotes included in this outlook commentary are published as endnotes in the back of this whitepaper.

Strong Performance but with Increased Dispersion of Returns

Senior secured leveraged loans posted their second-best annual return since the Credit Suisse Leveraged Loan Index ("Index") began in 1992. The Index returned 13.04% in 2023, and only the 44.87% return in 2009, the recovery year from the GFC, was higher. Many key factors helped drive the strong returns: higher base rates, continued economic growth, and solid corporate fundamentals. The Fed continued its hawkish stance on rates to fight inflation, increasing rates another 1% in four hikes in 2023. The current Fed Funds rate at 5.50% is the highest it has been since early 2001. For the loan market, that can be a blessing and a curse. The elevated base rates helped drive yields higher with the Index's yield to three-year takeout above 10% for much of the year, and the average coupon ended the year in the mid-9% range. As a result, interest income returns in 2023 totaled 9.77%, accounting for almost three-quarters of the total Index return. As with the private credit market, corporate fundamentals remained resilient throughout the year. This helped the market to achieve a 3.01% principal return, the seventh-highest annual principal return on record and the highest since 2016. The average price of the index increased from 91.89 at the start of 2023 to 95.32 by the end. As a result, credit spreads tightened in the market throughout the year, as the 3-year discount margin of the index fell 124bp, from 652bp to 528bp.

FIGURE 26

Credit Suisse Leveraged Loan Index Annual Peformance[23]



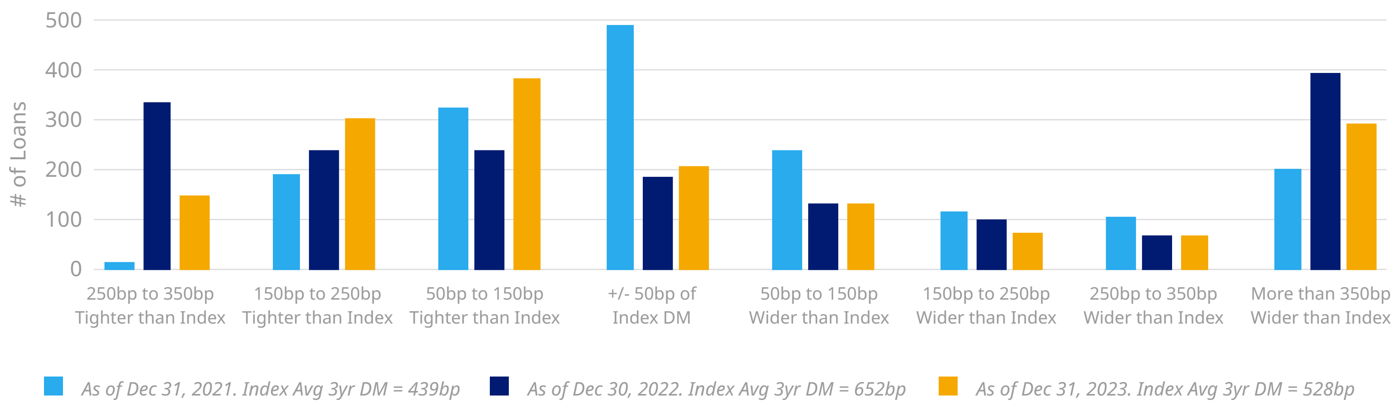
Early indications of economic growth in 2023 are stronger than previously predicted; the Bureau of Economic Analysis estimates a 2.5% growth rate last year versus consensus expectations of 0.3% growth rate at the beginning of the year. Moreover, 65% of economists surveyed by Bloomberg in early 2023 expected a near-term recession. While the economy did better than expected, the higher coupon rates did put pressure on some issuers. The trailing 12-month upgrade-to-downgrade ratio in the leveraged loan market was 0.58x in 2023, with $413bn of downgrades versus $240bn of upgrades, according to JP Morgan data. Defaults are also a key indicator of stress in the market. While default rates did increase in 2023 with the LTM par-weighted loan default rate reaching 3.15% in 2023 from 2.65% in 2022, default rates are just above the 25-year long-term average of 3.0%. It should be noted that default rates are often quoted inclusive of distressed exchanges, and there was a meaningful increase in distressed exchange activity in 2023. In fact, the $25.4bn of distressed exchanges in 2023 is the highest since 2008's $36.4bn.

In terms of supply and demand, leveraged loan gross issuance totaled $370.1bn in 2023. While gross issuance rebounded 47% from 2022's $252.5bn, most issuance in 2023 was used to refinance or reprice existing debt as borrowers took advantage of tightening spreads. According to JP Morgan data, refinancing and repricing were the two largest uses of proceeds in 2023, accounting for 58.7% and 19.2% of all new-issue activity, respectively. Therefore, 2023 net issuance totaled only $81.8bn, the lowest annual total since just after the GFC in 2010, which helped drive the 3% principal appreciation. However, the lower net supply was partially offset by lower demand coming from CLOs and mutual funds. Full-year 2023 CLO issuance totaled $115.8bn, about 10% lower than the previous year. While new CLO formation was the lowest since 2016, the market did not completely shut down despite equity arbitrage (the difference between asset spreads and the weighted average cost of financing) not being favorable for most of the year. Leveraged loan mutual funds saw $17.25bn come out in 2023, the highest outflows since 2020. Notably, five of the past six years have seen outflows from the loan mutual fund universe. While mutual funds themselves are an admittedly small part of the overall market at about 7.5%, they can be an indicator of broader non-CLO investor trends.

The rapid increase in underlying rates, high inflation figures, economic uncertainty, and loan market fundamentals have led to significant shifts in the dispersion of the loan market. At the end of 2021, a year with a total return of 5.40% of which 1.17% was price appreciation, nearly 30% of the market was trading with 50bp of the index average three-year discount margin of 439bp. The proverbial rising tide that lifts all ships played out in 2021. Starting in 2022, the overarching macro environment forced the market to differentiate between credits resulting in nearly half the market trading greater than 250bp wider (27%) or tighter (20%) than the index average by the end of the that year. While 2023 saw some reversion, the market remains very bifurcated, and investors are facing a bimodal market.

FIGURE 27

Dispersion of 3yr Discount Margin[23]



Yields to Fall but Remain High/attractive and with Less Credit Stress; Volume to Rise Modestly

With the new year comes the logical question of where the market goes from here. Trends in corporate fundamentals and market technicals for the leveraged loan market were showing signs of improvement towards the end of the year. We believe that many of those trends will continue into 2024. A few tailwinds will help drive the market:

- From a credit perspective, many borrowers have benefitted from the stronger-than-expected economy, and most will benefit from decreasing base rates.
- Our overall belief that rates may be "higher for longer" helps mitigate lower coupons for investors and creates an equilibrium between lower financing costs for borrowers and higher yields for investors.
- While still below 1 (more downgrades than upgrades), the upgrade-to-downgrade ratio by par amount improved significantly in the latter half of the year, improving from 0.48x in the first half to 0.73x in the second half. Similarly, default volume in the syndicated leveraged credit market (leveraged loans and high yield combined) totaled $55.1bn in the first half, and the total fell by nearly half to $28.4bn in the second half. Demand in the loan market has also improved, a trend we expect to continue into 2024. As mentioned earlier, loan funds saw over $17bn of outflows in 2023. However, the second half of the year saw modest inflows as the redemption activity was entirely concentrated in the earlier in the year when investors were more concerned about increasing rates and recession risk.
- While CLO formation was fairly evenly distributed across both halves of the year ($55.9bn in the first half versus $59.9bn in the second), the CLO market is poised for higher issuance as AAA spreads are coming in. Several managers have priced new-issue AAAs approximately 25bp tighter than just three months ago, according to a recent JP Morgan report. In addition, Secondary AAA spreads (discount margin) have fallen below to 135-140bp range, a level not seen since early 2022.

FIGURE 28

A Tale of Two Halves in the Loan Market[23]

	1H23	2H23	2023
Loan Index Return	6.33%	6.32%	13.04%
CLO Issuance ($bn)	$55.9	$59.9	$115.80
Leveraged Loan Issuance	$135.4	$234.7	$370.2
Repricing Volume ($bn)	$3.6	$67.4	$71.0
Leveraged Credit Default Volume ($bn)	$55.1	$28.4	$83.5
Loan Mutual Fund Flows ($bn)	($17.3)	$0.1	($17.3)
Upgrade/Downgrade Ratio (per amount)	0.48x	0.73x	0.57x

On the supply side, we expect to see marginally higher gross and net issuance in the loan market. The market has already seen a sizable increase in gross issuance this year with JP Morgan reporting nearly $120bn of gross issuance in January, more than every quarter in 2023 except 3Q23. Early indications of net issuance are also higher as 61% of issuance year-to-date has been used to refinance or repay older debt vs 78% in all of 2023. We expect this trend of more net issuance to continue in 2024 for several reasons. First, as discussed in one of our themes in the private credit market, we expect M&A volume more broadly to increase this year and continue into 2025. The increase has a similar effect for the broadly syndicated loan market to bring net new issuance. Secondly, we believe a number of private credit issuers may be looking at the syndicated market to refinance their debt as they seek out better terms. Ultimately, more issuance is another net positive for the market helping to keep a supply/demand equilibrium and increase diversity.

The technicals remain very strong and fundamentals should continue to be a net positive for the loan market especially if the economy performs as expected – growing 1.5% in 2024, according to a recent Bloomberg survey. However, some parts of the market remain challenging. We expect credit impairments and defaults could pick up later this year as some borrowers struggle to grow top-line revenue and have already done cost-cutting measures. Along with our earlier theme of "fat tails" in the private credit market, we also expect a divergence in the syndicated loan market whereby the better credits continue to price well and tap the market for new issues and refinancing while there may also be a growing number of borrowers entering the bottom rung. The Index reported that 7.3% of all borrowers had a price below 80 as of December 31st. It hit a high of nearly 10% early in 2023, a number we could re-approach later in the year. However, at the same time, the percentage of loans trading above par has increased to 34% ultimately leading to greater dispersion in the loan market. Most managers will say they are bottoms-up fundamental credit pickers at heart, and 2024 may be just the market for them. We do believe there continue to be many good opportunities to put money to work at good relative value.

“The technicals remain very strong and fundamentals should continue to be a net positive for the loan market especially if the economy performs as expected – growing 1.5% in 2024, according to a recent Bloomberg survey.”

Conclusion

We believe that the current market environment remains favorable for direct lenders. Against a backdrop of sustained growth in U.S. middle market companies, 'higher for longer' interest rates and secular tailwinds that continue to power industry expansion, direct lenders are positioned to deliver attractive risk-adjusted returns in 2024. As we outlined, this ongoing secular shift is still in its early stages with considerable opportunity ahead as the asset class further develops into a core allocation across a broad range of investors.

Furthermore, we believe the opportunity set in credit, both private and public, remains compelling relative to other assets. In private credit, yields, leverage, defaults and spreads are all at levels that suggest 2024 could be a very attractive vintage for investors. In liquid credit, the technicals and fundamentals remain supportive. Borrowers are likely to benefit from continued economic growth and lower financing costs while rebounding demand and still attractive yields should benefit investors.

Looking ahead, while there will no doubt be periods of volatility driven by negative headlines and macro and geopolitical headwinds, we remain optimistic and expect a continued recovery in the economy to provide a supportive backdrop for credit performance in 2024.

Note: Unless otherwise stated, statements above reflects Antares' beliefs. Past performance is not a reliable indicator of future performance and future results may differ materially. Cross-referenced footnotes included in this outlook commentary are published as endnotes in the back of this whitepaper.

Sources:

1. Cliffwater LLC and Bloomberg
2. Meant to be approximately representative only. Note that most private deal stats are not available prior to 2013, so some data series have been spliced with syndicated sponsored middle market data historically prior to 2013 to include perspective pre and post Global Financial Crisis. Sources: LBO Equity Contribution is from LSEG LPC – syndicated middle market 2007-2012; Private + Institutional 2013-2023; LBO Total Debt to EBITDA from LSEG LPC – institutional middle market LBOs (with average quarterly EBITDA range of $40-60M); LBO EBITDA/Cash Interest from Pitchbook LCD - both middle market and large LBOs; All-in Spread to Leverage Ratio from LSEG LPC – MM 1st lien direct lending excluding unitranche back to 2015, and Institutional MM LBOs back to 2007; Middle Market Yield Premium vs BSL from LSEG LPC
3. Federal Reserve Bank of Chicago
4. Cliffwater LLC and Bloomberg. Represents average 24M performance for the two prior easing cycles - Jun 07 - May 09 and Aug 19 - Jul 21
5. LSEG LPC as of 4Q23.
6. Federal Reserve Selected Assets and Liabilities of Commercial Banks in the United States
7. Preqin
8. Middle market is defined as companies with EV <$5B and companies with revenues $5M – 2.5B. Source: Antares Capital, Pitchbook LCD, Preqin and U.S. Census
9. Pitchbook LCD
10. LSEG LPC as of 4Q23
11. St Louis Federal Reserve FRED database
12. Pitchbook LCD
13. Cliffwater LLC and Bloomberg
14. LSEG LPC. Based on private data submissions, which include both syndicated and direct execution deals excludes unitranche and second-lien term loans. Beginning 1Q22, data includes LIBOR and SOFR based deals. *Libor loans = 3-month Libor rate. Term SOFR loans = 1-month TSOFR+CSA if available
15. LSEG LPC. Data calculated by combining private data submissions with public league table submissions, excludes unitranche and second-liens. Beginning 1Q22, data includes LIBOR and SOFR based deals, spreads do not include CSAs, unless embedded
16. Cliffwater Asset Allocation Outlook 4Q23. There can be no assurance that any expected rates of return or risk will be achieved. Expected rates of return and risk may be based upon assumptions regarding future events and conditions that prove to be inaccurate. Expected rates of return and risk should not be relied upon as an indication of future performance and should not form the primary basis for an investment decision. The index returns are provided for information only. Reference to an index does not imply that a portfolio will achieve returns, volatility, or other results similar to the index.
17. Bloomberg
18. Cliffwater LLC and Fitch
19. Bloomberg and Cliffwater LLC.
20. Fitch
21. Cliffwater LLC as of September 30, 2023.
22. Preqin. Includes performance of both levered and unlevered funds.
23. Credit Suisse; Pitchbook LCD; JP Morgan

Disclosure for Marketing Brief and Marketing Research/Outlook

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